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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 147

M. A. HOLMES,

Petitioner,

vs.

CHARLES J. McCOLGAN, as Bank and Corporation Franchise Tax Commissioner of the State of California,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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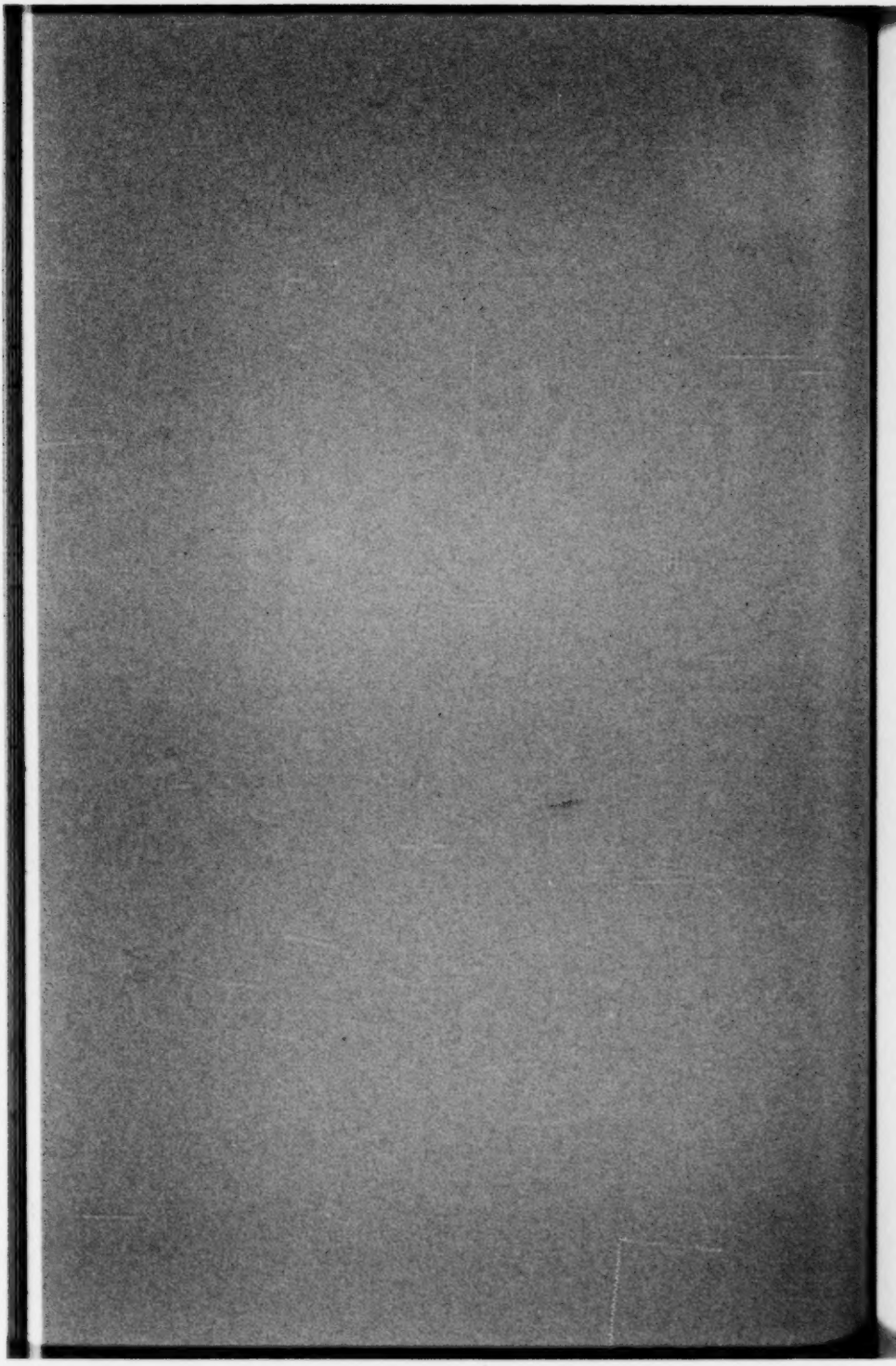

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STATEMENT OF THE CASE

The case is correctly stated on pages 10 and 11 of the Brief in Support of the Petition, and Respondent therefore accepts that statement of the case.

SUMMARY OF ARGUMENT

Respondent's argument will follow the same pattern that Petitioner used in his brief, with the headings rephrased to state Respondent's position.

It is Respondent's position, as elaborated in the argument hereinafter, that the retroactive application of the California Personal Income Tax Act to January 1 of the year in which the act was enacted is constitutional and is supported by decisions of this Court. Respondent will also show that the effect of the act in taxing preexisting increment to capital when realized after the applicable date of the act not only does not raise a federal question but is in accord with the principles of income taxation which have been enunciated by this Court. Finally, we will show that the conflict of the decision of the California Supreme Court with decisions of courts of other states is not a conflict of nationwide importance, for the California court rested its decision on decisions of this Court which were rendered after the decisions of the state courts which are said to be in conflict with the decision of the California court.

ARGUMENT

Point I

The Provision of the First Personal Income Tax Act of California Making It Apply to the Gains Upon a Voluntary Sale Realized After the Applicable Date But Before the Effective Date of the Act Is Not Unconstitutional

Not one of the decisions of this Court relied upon by Petitioner in this division of his brief is in point, for each of them involved taxes on gifts, whereas the instant case involves a tax on net income. The distinction is apparent from the decision in *Cooper* v. *United States,* 280 U. S. 409, as well as from *Welch* v. *Henry,* 305 U. S. 134.

Cooper v. *United States,* 280 U. S. 409, like the case at bar, involved a retroactive income tax on capital gain of a type not theretofore taxed. The *Cooper* case upheld the Revenue Act of November 23, 1921, which applied to income for the entire year 1921. Prior to this revenue act, gift property in the hands of the donee had a basis for income tax purposes equal to its value at the time of gift, so that if the donee sold the property he was not taxable on income unless the selling price exceeded the value of the property when it was given to him. The 1921 act, however, reduced that basis for computing gain on the sale of gift property from its value at the time of the gift to the cost or other basis to the donor. Thus under the amendment the

donee would be taxable on income when he sold the property, regardless of whether the selling price exceeded the value of the gift, to the same extent that the donor would have been. This happened to Mrs. Cooper, who sold property given to her by her husband for a price which was exactly equal to the value of the property when it was given to her but which was in excess of the cost of the property to her husband. Both the gift and the sale occurred prior to the enactment of the statute. Had the statute imposed a gift tax on the donor it would have been invalid under the cases on which Petitioner relies. But the donee, who benefited from both the gift and the sale, was the one who was taxed. Although the tax on the donee's income was on a value which was entirely a gift to her, the retroactive tax was held valid. The Court, unanimously and speaking through a member of the majority which decided the cases relied on by Petitioner, held that those cases were not in point in considering the validity of income tax legislation.

The *Cooper* case, which must have influenced the California Supreme Court since it was cited in Respondent's briefs before that court, is not distinguishable from the instant case on the ground that in the *Cooper* case there was an established policy of taxing such gains and the statute was merely amendatory of that policy. Never, before the retroactive act of 1921 upheld the *Cooper* case, was the value of gifts made subject to the

income tax. That act, like the one herein in question, imposed the first tax on the subject which it taxed, and its retroactivity was upheld.

Welch v. *Henry,* 305 U. S. 134, is likewise not susceptible to the distinction offered by Petitioner. The income which the 1935 Wisconsin legislation taxed retroactively had theretofore been exempt from the state income tax, so necessarily the retroactive tax reached a new subject. Thus it did not differ in its material aspects from the instant tax, except in degree of retroactivity, in which the Wisconsin tax far exceeded the California tax.

The attempted distinction regarding amendatory laws which Petitioner offers is born of language in *Milliken* v. *United States,* 283 U. S. 15, where, however, the Court made it very clear that the subject taxed by the retroactive 1918 act was also taxed by the 1916 act. In the *Cooper* case, in *Welch* v. *Henry* and in the instant case the subject retroactively taxed was never before taxed. Thus the distinction Petitioner offers is inconsistent with this Court's decisions.

If, however, one momentarily assumes that Petitioner's distinction has merit and that the retroactive federal tax and retroactive Wisconsin tax on new subjects were upheld only because they emerged from the shelter of pre-existing policies of taxing some incomes (though not those which the amendment taxed), the California tax is nevertheless valid for the same reason. Since 1929 cor-

porate net incomes had been used as the measure of the California franchise tax; thus since 1929 California had had the policy of using net income as a tax base, and its action in 1935 in extending the income tax principle to include individuals' incomes was only amendatory of a preexisting policy.

The real distinction, however, between the gift tax cases and the income tax cases is not that offered by Petitioner but is that which is suggested by the following quotation from the opinion of the Court in *Welch* v. *Henry,* 305 U. S. 134, 148:

> "Similarly, a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that *their receipt would later be subjected to a new tax* or to the increase of an old one." (Emphasis added.)

The income tax is on profits, on gains, whereas the gift tax is on an act unprofitable and actually costly to the one who is taxed. It is reasonable to assume that one would not have made a gift if he had known that he would be taxed for the privilege, but it is altogether unreasonable to assume that one would have refused to sell property at a profit to avoid a tax which would take but a part of it. Thus we find the Court stating in the above quotation that even a new retroactive tax on profits is not prohibited by the gift tax cases.

The decision in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, likewise fully supports the validity of this tax. Petitioner offers three possible distinctions, none of which has merit. The first distinction is not clear, but it either does not deal at all with retroactivity or, if it does, is a complaint because the California act does not tax all gains realized after March 1, 1913. If the former construction is the correct one, this distinction will be answered later, under Points II and III. If the latter construction is correct, no answer is necessary. The second offered distinction simply is that in the *Brushaber* case there were numerous profitable transactions, whereas in the instant case there were sales of only two properties. But surely the Constitution affords equal protection to those who must engage in numerous transactions to earn profits and to those who need engage in only two. The basis of this attempt distinction is that Petitioner might have foregone his profits rather than pay any of them in taxes to the State of California. As we have seen, this Court has previously found a like assumption too violent. The third distinction is that the Railroad Company had warning whereas Petitioner did not. This distinction has the same faulty basis as the second one, but there is an additional answer to it. In 1933 the California legislature passed a personal income tax act which the governor vetoed. The next legislative session at which revenue bills could be passed was in 1935, and in that year there was as great a need for new

state revenue as in 1933, and, perhaps more important, a new governor. It would have taken no more political acumen to foresee the passage in 1935 of the California act than it would have taken in 1913 to foresee the passage of the 1913 income tax act. Petitioner had the warning to which he claims he was entitled.

Petitioner also seeks to place his case outside the boundaries of the decisions discussed above by asserting that the Personal Income Tax Act did not equalize the costs of government. The basis for this contention is that those who received income during 1933 and 1934 escaped tax, whereas he did not. However, Petitioner did not receive income in 1933 and 1934, for the unrealized increment to his property was not income in those years. Had the state income tax been in effect in those years Petitioner would have escaped tax for those years whereas those who received income would have been taxed. Petitioner received his income in 1935 and he, in common with those others in California who received income in that year, was taxed. Actually this complaint of Petitioner should not have been directed against the retroactivity of the tax, which had nothing to do with the basis on which this complaint is founded, but rather against the fact that the act uses cost as the basis for computing capital gain instead of January 1, 1935 value. As Petitioner attacks the act on this ground elsewhere, we will answer that attack in a later division of this brief.

Point II

The Provision of the First Personal Income Tax Act of California Taxing Income Resulting from Capital Increment Accrued Prior to the Date from Which the Act Was Made Applicable Is Not Unconstitutional

In the title to this division and hereinafter we will accept the use of the word "accrue" and its participles which Petitioner has adopted, although actually the word has become a word of art in tax law, and as such does not have the meaning Petitioner gives to it. Actually Petitioner's gain did not "accrue" until after January 1, 1935.

Lucas v. *North Texas Lumber Co.*, 281 U. S. 11.

The meaning of the word "accrue" was pertinent in a contention, involving the interpretation of the act, unsuccessfully raised by Petitioner in the state courts. As it is no longer pertinent, we will not further protest the somewhat misleading use of that word.

A. Such a Provision Is Not So Arbitrary and Capricious As to Amount to a Denial of Due Process of Law

Petitioner erroneously states that the opinion of the Supreme Court of California gave no consideration to this point. That court first stated that Petitioner contended that the act contravened the Fourteenth Amendment to the Constitution and then held that this contention was already settled adversely to Petitioner in *Fullerton Oil Co.* v. *John-*

son, 2 Cal. (2d) 163, 39 Pac. (2d) 796. This will appear on pages 34 and 35 of the Appendix to the Petition for Certiorari, where the opinion of the state court is printed.

Petitioner objects to the use by California of March 1, 1913 values and points out that that date has no particular relation to California taxes. It is, of course, true that March 1, 1913, has no particular relation to the California tax system; however, the incorporation by reference of the federal statutory provisions which use March 1, 1913, values as an alternative basis for computing capital gain has the effect of using 1913 values solely as a relief provision. The legislature need not have granted taxpayers this relief (Compare *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, pointing out that deductions from income are a matter of legislative grace) and its action in having done so is not a cause for constitutional objection. The advantages in copying the federal system are pointed out in the opinion of the California Supreme Court.

The legislative action in taxing all capital gain realized on or after January 1, 1935, results in placing all fortunate property owners on the same plane with those whose earnings come from personal services. All who realized profits on or after January 1, 1935, were taxed regardless of whether those profits were in the form of capital gains, dividends or salaries. The legislature chose a class of taxpayers and laid a tax burden on those taxpayers

which varied according to the benefits enjoyed during the taxable period and the ability to pay.

Petitioner received large monetary benefits during the taxable year and possessed the ability to pay. Although he contends that the tax on him is arbitrary and unreasonable, his possession of the benefits which governments make possible and protect fully justifies his being taxed on those benefits.

Petitioner's argument in this division of his brief is based on two asserted wrongs: one, that the act taxed him retroactively because it taxed him on increment arising before but not realized until after January 1, 1935; two, he is treated unjustly in comparison with those who realized the increment to the value of their property before 1935. The first argument is faulty because the act taxed him on income and his increment did not become income until 1935. Unrealized appreciation in value has never been treated as income and this Court has held that it may not be treated as income under the Sixteenth Amendment.

Eisner v. *Macomber,* 252 U. S. 189.

The practice of taxing capital gain as income only when it has been realized by sale or exchange is well-settled and has judicial approval. See *Merchants Loan and Trust Co.* v. *Smietanka,* 255 U. S. 509, and *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244. An action is arbitrary and capricious only when it is an unjustified departure from the normal standards of conduct, and such a reli-

gious adherence by the California legislature to the normal concepts of income can not, we submit, be properly characterized as either arbitrary or capricious.

The second assertion of a wrong is faulty for the same reason that the first one is. Those who realized their profits before 1935 received their income before that year whereas Petitioner did not. It is proper to treat differently people situated so differently.

The final answer to Petitioner's assertion that he was denied due process because he was taxed in 1935 on increment existing before that year but realized during it is that this Court has already held an identical objection insubstantial in *Glenn* v. *Doyal,* 285 U. S. 526. *Glenn* v. *Doyal* involved an appeal from the Georgia Supreme Court, which had upheld the first income tax of Georgia in its application to increment existing before 1929 but realized in that year, when the Georgia act was passed. This Court dismissed the appeal because it did not involve a substantial federal question. We submit that that decision establishes that Petitioner's objection is insubstantial.

We note that Petitioner, in this division of his brief as well as in a prior one, contends that he was injured because he had no advance warning that this tax act would be enacted. Although he has no constitutional right to such warning, as we pointed out in the first division of this brief he had the warning to which he claims he was entitled.

B. Such Provision of the Act Does Not Constitute a Denial of the Equal Protection of the Laws

Petitioner has not been discriminated against in any manner. As we pointed out above, under long established concepts of income taxation Petitioner's gain became income for the first time in 1935. He seeks to compare himself with those who realized their capital gains in prior years and whose gains accordingly became income in those years, but he can not justly claim that he must be taxed as if his gain had likewise become income before 1935. There is no discrimination in treating those who receive income in 1935 differently from those who received income from similar sources in years before 1935. While we believe this fact to be self-evident, it is emphasized by realizing that if such different treatment is unconstitutional a state can not validly increase its rate of taxation on gains unless it does so retroactively.

Petitioner's income was not in existence before 1935, although the source of it was. He was in the same situation as a skilled professional man or workman who derived earnings in 1935 from a hard-won proficiency acquired in prior years, but his argument would not exempt these other persons. To exempt Petitioner's gain as he asks would not avoid discrimination against him but would, on the contrary, create the most gross discrimination in his favor and against those who must be content

with the earnings their personal services may bring them.

Possibly it was these considerations which led this Court to conclude in *Glenn* v. *Doyal,* 285 U. S. 526, also discussed above, that a similar argument did not present substantial federal questions. That decision is authority against both of Petitioner's arguments in Point II of his brief.

Point III

The Decision of the Supreme Court of California in This Case Is Based Upon a Correct Interpretation and Application of the Decisions of This Court

The third division of Petitioner's brief merely refers to Petitioner's previous attempted distinction of *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1, and *Welch* v. *Henry,* 305 U. S. 134, and therefore we need not do more than refer to our own previous discussion of those cases in the first division of our brief.

This division of Petitioner's brief is principally devoted to an attempt to show that the decisions of this Court in *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244, *Merchants' Loan & Trust Co.,* v. *Smietanka,* 255 U. S. 509, and *Eisner* v. *Macomber,* 252 U. S. 189, were misinterpreted by the California Supreme Court and do not actually support the validity of the act. Petitioner attempts to distinguish *Eisner* v. *Macomber* by pointing out that the actual decision involved the taxability of common stock dividends and not of capital gains.

This attempted distinction completely overlooks the fact that *Eisner* v. *Macomber* has been more often cited by this Court as well as by others for its reasoning than for its decision. The California court cited the case, as has this Court times without number, for the generalization which it fathered that gains do not become income until they are realized. *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, was cited by the California court as sustaining that same proposition, and even Petitioner admits on page 7 of the Petition that the case supports that proposition.

When it decided *Fullerton Oil Co.* v. *Johnson,* 2 Cal. 2d 162, 39 Pac. 2d 796, the California court relied on *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244; in which a taxpayer contended that its capital gain had become capital during a period when capital gains were not taxed and therefore the gain could not be taxed as income in the year of realization. This Court held that the gain was taxable when realized even though it was merely a realization of increment which arose during years when capital gain was not taxed. Petitioner attempts to distinguish that case from the present one because in the *Alliance Insurance* case Congress had once before taxed capital gains although none of the increment to the taxpayer's property arose during years when such gain was taxable. Apparently it is Petitioner's notion that the fact that Congress had once taxed capital gains operated as a caveat to property owners, warning them

that if they permitted their property to increase in value they did so at their peril for they might be taxed if they should sell it at a gain. If this is the notion behind the attempted distinction it nevertheless would not be pertinent unless one were to assume that Petitioner would not have permitted his property to increase in value and would not have sold it for a gain had he had a similar caveat. Such an assumption would be quite unreasonable.

The conclusion is compelled that the fact that Congress once before had taxed capital gains whereas California had not has no bearing on the validity of either the 1928 federal tax or of the California tax under the Constitution. The *Alliance Insurance* case was therefore good authority for the California courts.

If, however, one assumed that the California Supreme Court had misinterpreted *Eisner* v. *Macomber, Merchants' Loan & Tr. Co.* v. *Smietanka,* and *MacLaughlin* v. *Alliance Insurance Co.,* that fact would not present a federal question. Those decisions interpreted the Sixteenth Amendment, by which California is not bound or its powers enlarged. California may define income differently from Congress without offending the United States Constitution. The California concept of income is a local question except where a contravention of the Fourteenth Amendment is concerned, and the authorities discussed above show that no denial of due process or equal protection is involved herein.

Point IV

The Decisions of Courts of Other States Which Are in Conflict with the Decision of the California Supreme Court Are Likewise in Conflict with Subsequent Decisions of This Court

Certain decisions of other state courts are stated by Petitioner to be contrary to the decision of the California Supreme Court, but those decisions are also contrary to subsequent decisions of this court.

State v. *Nygaard,* 163 Wis. 307, 158 N. W. 87, holds that increment existing before the enactment of a taxing act but realized thereafter is not taxable. It is inconsistent with the decision below, and also with *Glenn* v. *Doyal,* 285 U. S. 526, and *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244. Both decisions of this court were rendered after the *Nygaard* case was decided.

Trefry v. *Putnam,* 227 Mass. 522, 116 N. E. 904, merely states that the problem is serious, but if one interprets the case as being in conflict with the decision below, the comments made about the *Nygaard* case become applicable.

Norman v. *Bradley,* 173 Ga. 482, 160 S. E. 413, is in accord with the California court's decision on the problem on which it conflicts with the *Nygaard* decision, but the *Georgia* case conflicts with the California decision regarding the validity of the retroactive feature. However, the *Georgia* decision also conflicts on that point with the subsequent decision of this Court in *Welch* v. *Henry,* 305 U. S. 134,

as well as with the earlier decisions in *Cooper* v. *United States,* 280 U. S. 409, and *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1.

State Revenue Commission v. *Lazear,* 179 Ga. 167, 175 S. E. 451, is in conflict with decisions of the California Supreme Court and this court to the same extent as *Norman* v. *Bradley.*

Thus each of the decisions by courts of other states in conflict with the decision of the California Supreme Court is likewise contrary to a decision by this Court rendered subsequently to the decision by the other state court. There is no reason to believe that future decisions by state courts will not follow the already existing decisions of this Court, and if any state court should be indisposed to follow the already existing decisions of this Court it would probably be equally indisposed to follow any decision by this Court of the instant case.

We submit that a decision by this Court is not necessary to clarify the law, for decisions by this Court have already clarified it.

CONCLUSION

We urge that the Petition for Writ of Certiorari be denied.

Respectfully submitted.

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